Accountant explains how taxes take a big bite out of N.J. lotto jackpot

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STEVE HOCKSTEIN/FOR THE STAR-LEDGERMichael H. Karu, CPA/CFF, in his office at the firm of Levine, Jacobs & Company in Livingston

Those dreams the New Jersey State Lottery promise for a dollar should come with some fine print: Taxes will shrink the dream -- quite substantially.

The federal government always took a share of lottery winnings in New Jersey, but motivated by a severe budget shortfall, the state government recently decided to take a portion of prize money too.

The state tax is also retroactive to Jan. 1, 2009.

"If I had won a sizeable prize," said Livingston accountant Michael Karu, "I would be annoyed."

Karu, who is a co-managing member of Levin, Jacobs & Co., explained in detail how taxes reduce a winner's prize money and how the retroactive provision also impacts winners who choose to take their prize in annuity payments over 20 years. He also offered a taste of the advice he might dole out to a new lottery winner.

WHAT IT ALL MEANS

Q: There may be little empathy for lottery winners who are getting taxed by the state, but give us the details. What does the new tax, coupled with a long-standing federal tax, actually mean for someone with a winning ticket worth, say, $24 million?

A: Assuming the Mega Millions jackpot is $24 million and there is one winner and that person elects to take the cash payout rather than the 20-year annuity, that person would receive a gross payout of roughly

$16 million.

Of that $16 million, they will need to pay federal tax of 35 percent, or $5.6 million, and state tax of 10.75 percent, or $1.7 million, leaving them with a net of $8.7 million. If they take the annuity, that $24 million divided by 20 is $1.2 million a year and then they're taxed on that each year.

The federal tax would be less and the state tax would be less because it won't be at the highest tax bracket. If you're told you won $24 million but when the dust settles you get $8.7 million, or a little over a third, it's almost like a bait and switch.

The program is designed to sell a big number. No one really wants to hear that they're really only going to get a third. It's a big reduction.

Q: Have you started getting calls from clients about the lottery tax?

A: It doesn't effect that many people. Usually, we would get the call after the fact. It's not a major impact for someone who wins $20,000 or $30,000. When you look at the 10 people from Chubb who shared a $216 million jackpot, it's a huge number.

If someone plays the lottery, they won't worry about the tax until they win. It's similar to someone who goes to a golf outing and has the chance to win a car if they hit a hole-in-one.

They have to pay the tax on that car, but they don't really think about that. They don't say, 'Why should I try to win because I don't want to pay the tax.' They're going to play.

Q: Why did the state decide to tax the winnings rather than the purchase of the lottery ticket similar to the way it taxes cigarettes?

A: The ultimate seller of the product is the state, and the state is tax exempt. There would be no precedent. That would literally change the whole tax structure of the state.

Q: When it comes to taxes on lottery winnings, how does New Jersey compare to other states?

A: One of the great inducements in New Jersey has been if you win, it's tax free. Someone who lives in New York City or Philadelphia and plays the lottery will pay a higher tax. Delaware doesn't tax at all.

Q: What do you make of the retroactive provision?

A: I'm not an attorney, but to me, it's questionable. If I won $10 million and now it's going to cost me $1 million in tax, it would behoove me to test the law even if I have to spend $110,000 to do it.

There's a lot at stake. It also effects winners who receive annuity payouts. Say 11 years ago, I won $50,000. Everything I received through 2008 was tax exempt, but the dollars from Jan. 1, 2009 and later are subject to the tax.

Q: What advice would you give clients who win a lottery jackpot and then face the reality of paying federal and state taxes on their winnings?

A: I would ask them how big a family they have, how many brothers, sisters and children who file their own tax returns. I would advise them to spread the wealth. There's nothing that says the winner can't say everyone is getting a percentage.

The overall tax would be lower. If someone is philanthropically inclined, I would encourage them to take advantage immediately rather than waiting a year.

One of the other things, if you do win a large amount, and it is near the end of a calendar year, you can always wait until the following calendar year. If you wait until January, you can hold onto a much larger portion of it for a longer period of time.

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